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In the

Supreme Court of the United States

OCTOBER TERM, 1977

HARVEY L. BELL,
Securities Commissioner for the State of Arkansas,
Petitioner,

vs.

INTERNATIONAL TRADING, LTD.,
A division of GNB, Inc., J.R. Rose and Arthur Palmer,
Repondents.

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF ARKANSAS

JOEL J. BELLOWS
CHARLES B. BERNSTEIN
100 North LaSalle Street
Suite 1100
Chicago, Illinois 60602
Attorneys for Respondents

The Schaffer Press, Inc.—(312) 263-6850

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ARGUMENT

SECTION 201 OF THE COMMODITY FUTURES TRADING COMMISSION ACT OF 1974 (CFTCA), 7 U.S.C. §§2, 4, PREEMPTED ALL ACTIONS BY A STATE SECURITIES COMMISSIONER WITH REGARD TO COMMODITY OPTIONS.

To understand the thrust of the preemption provisions of §201 of the Commodity Futures Trading Commission Act of 1974 (CFTCA), a review of the history of the regulation of commodity options must first be made.

The Commodity Exchange Act, 7 U.S.C. §§1 *et seq.*, was enacted in 1922 to govern the commodity futures markets. Johnson, *The Commodity Futures Trading Commission Act: Preemption as Public Policy,* 29 Vand. L. Rev. 1, 2 (1976). It was amended in a hodge-podge fashion over the years in order to bring additional commodities under its regulatory aegis. *Id.* at 3-4.

A commodity option is a contract right, purchased from the option seller for a fee called the "premium," to buy from, or sell to, the option seller, the underlying commodity futures contract at a fixed price called the "striking price," at any time during the life of the option. The striking price is usually the market price of the underlying commodity futures contract on the day that the option is sold. The option period is usually fixed, ranging from one month to a year or 18 months. An option to sell the underlying commodity futures contract is known as a "put." An option to buy the underlying commodity futures contract is known as a "call." It is also possible for the option purchaser to buy both a put and a call on the same commodity at the same time. Such a purchase is known as a "straddle," or, more commonly, as a "double option." Long, *The Naked Commodity Option Contract as a Security,* 15 Wm. & Mary L. Rev. 211, 212-14 (1974). A commodity option is considered a more conservative investment than a commodity futures contract because the risk of loss is limited to the premium paid and is not a concomitant of price fluctuations in the commodity which may lead to additional margin calls. Note, *Federal Legislation for Commodity Option Trading: A Proposal,* 47 So. Cal.L.Rev. 1418, 1424-25 (1974).

Commodity option contracts in various forms have been present in the financial market place for a number of years. Before 1934, contracts on domestic commodities,

such as wheat and cotton, were traded extensively on the major American exchanges. In that year, however, the Commodity Exchange Authority (CEA) banned trading in options on domestic commodities because of the abuses which had developed in the commodity option market. Trading in international, or "world" commodities, including silver, silver coins, platinum, cocoa, plywood, copper, coffee, and world sugar, was not affected, since such items were not subject to CEA jurisdiction. Long, *op. cit. supra,* pp. 213-14.

A "London option," which is involved here, is an option on an underlying futures contract traded on the London commodity exchanges. The options are issued, or "written," by the same exchanges. "World" commodities such as sugar, cocoa, coffee, rubber, silver and copper are traded on the London exchanges. *Clayton Brokerage Co. v. Mouer,* 520 S.W. 2d 802, 804 (Tex. Civ. App. 1975), *rev'd on other grounds,* 531 S.W. 2d 805 (Tex. Sup. Ct. 1975); Long, *op. cit. supra,* p. 214.

Upon this inconsistent scene where options on domestic commodities were prohibited and options on world commodities were not regulated, entered Harold Goldstein. Beginning in April, 1971, he parlayed, in less then two years, an investment of $800 into Goldstein Samuelson, Inc., a corporation with more than 100 outlets throughout the world, selling over 175,000 "naked" options valued at $88 million. *Id.* at 214.

A "naked" option, unlike the London options involved here, is simply a bet between the option seller and the investor that the price of a given commodity futures will rise or fall during a particular time period. The option seller does not maintain adequate inventories of the underlying futures and there generally is no intent that they

will even change hands. A naked option, therefore, is quite unlike conventional commodity option contracts, which normally do involve the actual exchange of the underlying commodity futures contracts upon the exercise of an option. *Id.* at 211-12, 219.

Goldstein's success caused the formation of other option firms. In late 1972 and in 1973, various state securities commissioners, concerned about Goldstein's business practices and recognizing that Goldstein had sagaciously stepped through an unregulated loophole, obtained cease and desist orders closing his business on the grounds that naked options were securities and that he had failed to register them and was selling them fraudulently. *Id.* at 214-17. (In the instant action, there was no allegation or evidence that the London option sold by Respondents were "naked" options.)

These administrative actions caused a run on Goldstein's bank, forced him into bankruptcy, and left sadder but wiser option investors with claims of between $14 and $85 million. *Id.* at 218 n. 28.

The Goldstein debacle inspired recognition of the meager and inconsistent federal and state regulation of commodity futures and commodity options. Congressional hearings commenced in the summer of 1973 to consider legislation overhauling the Commodity Exchange Act. Johnson, *op. cit. supra,* 1-7. These hearings resulted in the enactment by Congress on October 18, 1974, of the Commodity Futures Trading Commission Act of 1974 (CFTCA), 88 Stat. 1388 (1974). Senator Herman Talmadge, chairman of the Senate Committee on Agriculture and Forestry, expressed the intent of Congress in enacting the CFTCA:

> "It was the intent of the Committees to fill all regulatory gaps—to regulate trading in futures and *in options relating to commodities or commodity futures,* because such trading is now poorly regulated, *if it is regulated at all.*" (Italics added.) Staff of Senate Comm. on Agriculture and Forestry, 93d Cong., 2d Sess., Commodity Futures Trading Commission Act of 1974 6 (Comm. Print 1974).

The CFTCA, which became effective on April 21, 1975, provided, after several revisions in committee, as follows:

> "Sec. 201. Section 2(a) of the Commodity Exchange Act, as amended (7 U.S.C. 2, 4), is amended—
>
> • • •
>
> (b) By striking the period [after the words orange juice] and substituting therefore the following: 'and all other goods and articles, except onions as provided in Public Law 85-839, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in: *Provided,* That the [Commodity Futures Trading] Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty'), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 5 of this Act and transactions subject to regulation by the Commission pursuant to section 217 of the Commodity Futures Trading Commission Act of 1974: *And provided further,* That, *except as hereinabove provided* [Italics added], nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws." 88 Stat. 1395 (1974).

As the Senate Committee on Agriculture and Forestry stated:

"The [Senate] Committee Amendment retains the provision of the House bill but adds three clarifying amendments. The clarifying amendments make clear that (a) the [Commodity Futures Trading] Commission's jurisdiction over futures contract markets and other exchanges is exclusive and includes the regulation of commodity accounts, commodity trading agreements, and *commodity options;* (b) the Commission's jurisdiction, where applicable, supersedes State as well as Federal agencies; and (c) Federal and State courts retain their jurisdiction." (Italics added.) S. Rep. No. 93-1131, 93d Cong., 2d Sess. 6 (1974).

Thus it is clear that Congress considered the role of the SEC and the state securities commissioners in the commodity field and eliminated any claim to jurisdiction. The Commodity Futures Trading Commission Act of 1974 clearly preempts the SEC and state securities commissioners from all jurisdiction regarding commodity options and grants exclusive jurisdiction in this area to the new Commodity Futures Trading Commission (CFTC).

The courts have recognized that the securities commissioner of Texas and the SEC were preempted by the CFTCA from bringing suit to enjoin the sale of commodity futures and commodity options on the grounds that they were not registered as securities and were being sold fraudulently. *Clayton Brokerage Co.* v. *Mouer,* 531 S.W.2d 805 (Tex. Sup. Ct. 1975), and *Texas* v. *Monex Int'l Ltd.,* 527 S.W. 2d 804 (Tex. Civ. App. 1975), *applications for writ of error refused* (Tex.Sup.Ct. No. B-5658, December 17, 1975), faced the issue squarely and held that, even if, as the lower court had held, 520 S.W. 2d 802 (Tex. Civ. App. 1975), the London options were securities within the meaning of the Texas Securities Act, the

CFTCA preempted the state securities commissioners from regulation of commodity options and commodity trading advisors. *Accord, SEC* v. *Univest, Inc.,* 405 F. Supp. 1057 (N.D. Ill. 1975), which held that the CFTCA preempted the SEC from jurisdiction.

The CFTC also has repeatedly recognized that the state securities commissioners are preempted from taking action against commodity option dealers and commodity trading advisors.

In a CFTC Staff Interpretative Letter, the Office of General Counsel stated: "The House originally adopted an exclusive jurisdiction provision out of concern over 'A growing list of proposed and actual state regulations and laws moving into areas. . . such as commodity options. . .' and '[c]onfusion in court. . . as to traditional definitions of commodities and securities. . . .'"

"During Senate hearings on the 1974 amendments other so-called 'investment contracts' were then 'being subjected to a withering crossfire of disparate State regulation' and urged that Congress preempt 'well-meaning, but eccentric and ill-informed State attempts to regulate commodities markets under the guise of securities regulation.' See *Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113, Before the Senate Committee on Agriculture and Forestry,* 93d Cong., 2d Sess. pt. 3 at 681 (1974) (testimony of Glenn Willett Clark, Iowa Supt. of Securities). And, during Senate floor debates, it was recognized: 'Already many State laws are exercising jurisdiction over these same markets. . . . Varied and often conflicting regulation such as this could become a burden on Commerce, if it is not already.' 119 Cong. Rec. S. 11353 (daily ed. December 13, 1973). The Senate adopted a more pervasive grant of exclusive jurisdiction than the House and sought by clarifying language to '. . . make clear that where the jurisdiction of the [Com-

> mission] is applicable, it supersedes State as well as Federal agencies.' S. Rep. No. 93-1131, 93d Cong., 2d Sess. 23 (1974). According to Senator Talmadge, one of the principal sponsors of this legislation, 'This [was to] assure that the affected entities—exchanges, traders, customers, et cetera—will not be subject to conflicting agency rulings.' 120 Cong. Rec. S. 16128 (daily ed. September 9, 1974)." CFTC Interpretative Letter No. 76-19, *State Regulation of Commodity Options Preempted,* CCH Comm. Fut. L. Rep. ¶20,213 (September 29, 1976) at p. 21,158 n. 4.

In *Preemption of Authority to Regulate Trading Advisors,* CFTC Interpretative Letter No. 76-20, CCH Comm. Fut. L. Rep. ¶20,214 (September 29, 1976), the CFTC proclaimed:

> "The legislative history of the [Commodity Exchange] Act indicates that two of the major concerns that led Congress to amend the Act in 1974 were the inability of states adequately to regulate activities that are essentially national in scope and the need to avoid overlapping and duplicative regulation, which might result from the application of diverse and often conflicting state laws.
>
> "Public criticisms of the variegated pattern of non-stop regulation by the states, the Securities and Exchange Commission, the courts and the Commodity Exchange Authority—the predecessor agency to this Commission—were major factors leading to enactment of the CFTC Act." *Id.* at p. 21,161.

Finally, section 6c of the Commodity Exchange Act, 7 U.S.C. §13a-1 (Supp. 1977), now provides that enforcement actions pursuant to the CFTCA shall be brought in federal court. Thus it is clear that Congress intended to centralize regulation of the futures markets and commodity options in a single entity, the CFTC. Johnson, *The Commodity Futures Trading Commission Act: Preemption as Public Policy,* 29 Vand. L. Rev. 1, 30-31 (1976).

Article VI, §2, of the Constitution of the United States provides:

> "This Constitution and the Laws of the United States made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the Supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

Under the "supremacy clause," a state court must recognize federal law, and a federal law in conflict with a state law shall take precedence over the state law. *Testa* v. *Katt,* 330 U.S. 386 (1947); *Smith* v. *O'Grady,* 312 U.S. 329 (1941); *Riggs* v. *Del Drago,* 317 U.S. 95 (1942). This the Supreme Court of the State of Arkansas has correctly done.

At pp. 12-15 of its Petition, the petitioner seeks to persuade the Court that he was merely enforcing a criminal anti-fraud statute. However, it is obvious that the petitioner was acting in his role as a state regulatory agency to carry out the regulatory functions of the statute under which he was commissioned to operate. This action was not a criminal action which would properly be brought by a state attorney general or a county prosecuting attorney. On the contrary, it was a traditional regulatory proceeding, a suit for an injunction to prevent the respondents from selling securities. This is precisely the type of activity which proliferated in the wake of Harold Goldstein and which the enactment of the CFTCA sought to prevent. By regulatory agency, the CFTCA clearly did not mean to include traditional prosecuting officers whose powers are grounded in common law, but rather the state securities commissioners whose powers were established by a statute designed to regulate a specific

industry. Petitioner sets forth an erroneous conclusion when he says that no one but the CFTC could enforce action against persons effecting fraudulent transactions in commodities or from taking action against thieves who were stealing "raw commodities." (Petitioner's Br. 13.) It is obvious that the language of the statute extends only to preempt state regulatory agencies, particularly the state securities commissioners, and furthermore the statute specifically applies only to commodity futures contracts and not to "raw", or cash commodities.

Petitioner admits that the CFTCA is designed to preempt the SEC and the state securities regulators. (Petitioner's Br. 13.) It is not illogical that general anti-fraud statutes may be enforced while the specific regulatory scheme of a state blue sky law is preempted. The latter is the very type of dual regulation which the CFTCA sought to prevent. For example, in this case, the CFTC did not see fit to take any action against the respondents. Furthermore, the CFTCA was designed to eliminate the confusing and conflicting rulings regarding whether a type of transaction in commodities is a security. Rather, the CFTCA placed commodity regulation under its aegis so that state securities regulators would no longer have to go to the limits of the law to protect the public against commodities futures operators. Petitioner contends that by this suit he is not seeking to regulate commodities, but rather to enforce a criminal fraud statute. However, in the first place, an injunction action by the state securities commissioner can be sustained for reasons other than fraud, such as non-registration of the seller or of the security. Secondly, this is the very type of action which proliferated in response to the Goldstein debacle and led to the enactment of the CFTCA. Long, *The Naked Commodity Option as a Security,* 15 Wm. & Mary L. Rev. 211, 215-18 (1974). In these cases, the state securities

regulator stepped into the breach to enjoin commodity firms from selling what they termed and what was determined to be securities. The criminal sanction under section 21 of the Arkansas Securities Act, Ark. Stat. Ann. §671255 (Supp. 1977), is generated out of a civil proceeding and the standard of proof required for someone to willfully violate the Act is much different than for a party being prosecuted under a general criminal law statute. Petitioner sets up a straw man on page 15 by saying that either the State of Arkansas should be preempted completely or not at all. There is nothing inconsistent about preempting a state from regulation in a certain area, in a limited manner but complete as to those limits.

This is illustrated by *Rice* v. *Santa Fe Elevator Corp.,* 331 U.S. 218 (1947). In *Rice,* Congress had amended the United States Warehouse Act to provide that although the "Secretary of Agriculture is authorized to cooperate with State officials charged with the enforcement of State laws relating to warehouses, warehousemen, and their personnel, the power, jurisdiction and authority conferred upon the Secretary of Agriculture under this Act shall be *exclusive* with respect to all persons securing a license hereunder so long as said license remains in effect.'" (Italics added.) *Id.* at 224. The issue was whether, if a warehouse had a federal license, it must also obtain a state license from the parallel state regulatory authority. The Court said that Congress may, if it chooses, take unto itself all regulatory authority over warehouses, but that the Court must discern what the purpose of Congress was. *Id.* at 230. It applied the commonly accepted meaning of the word "exclusive" to conclude that Congress made it clear that it intended no regulation but its own. *Id.* at 235-36. The Court went on to state that if the matter on which the

State asserts its right to act is in any way regulated by the federal act, the federal scheme prevails, even though it may be a more modest, less pervasive regulatory plan than that of the State. *Id.* at 236.

In light of *Rice,* the attempted separation by petitioner of regulatory powers from enforcement powers is a distinction without a difference. Regulatory powers include those of enforcement as well as licensing. Any regulatory scheme which provides for licensing includes enforcement powers for failure to comply with the licensing provisions. The ordinary meaning of enforce is to compel obedience to or cause to be executed. *Commissioner of Public Health* v. *Board of Health of Tewksbury,* 350 Mass. 507, 215 N.E. 2d 745 (1966). "The word 'regulate'", on the other hand, "is one of broad import. It is the word used in the federal constitution to define the power of Congress over foreign and interstate commerce, and he who reads the many opinions of this court will perceive how broad and comprehensive it has been held to be. *City of St. Louis* v. *Western Union Tel. Co.,* 149 U.S. 465 (1893).

> "The term regulate is one of broad import, has a broad meaning, and is very comprehensive in its scope. . . . The power to regulate, it has been said, implies the power to check, and may imply the power to prohibit under certain circumstances; it implies the right to license, to prescribe rules and regulations for the conduct of the business regulated, and to rule and direct. . . .
>
> "The power to regulate, it has been said, carries full power over the thing subject to regulation, and that, in the absence of restrictive words, the power must be regarded as plenary over the entire subject. The power to regulate may include the power . . . to license; to refuse a license, to require bond from

> an applicant therefor, and to require the taking out of a license; to prescribe reasonable rules, regulations, and conditions upon which a business may be conducted or permitted; *to enforce them, and to prescribe punishment for violation thereof; to restrain* [Italics added.] . . . ." *Hollywood Jockey Club, Inc.* v. *Stein,* 133 Fla. 530, 542-45, 182 So. 863, 868 (1938), citing 53 C.J. 1172-76.

Exclusive regulation by the CFTC entails more than registration, notwithstanding the contention of petitioner. (Petitioner's Br. 15.) The appropriate state official would have much less desire to exercise his discretion in enforcing a general criminal fraud statute, with its higher burden of proof, than would the petitioner to bring a civil injunction suit under the Arkansas Securities Act. It is exactly this type of broad discretion which the CFTCA sought to preclude.

CONCLUSION

The Supreme Court of the State of Arkansas was clearly correct in its decision in this matter for the reasons stated herein, and respondents respectfully pray that petitioner's Petition for a Writ of Certiorari be denied.

Respectfully submitted,

JOEL J. BELLOWS AND
CHARLES B. BERNSTEIN
100 North LaSalle Street
Suite 1100
Chicago, Illinois 60602
Attorney for Respondents